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No. 731

In the Supreme Court

of the United States

OCTOBER TERM, 1958

KLAMATH MEDICAL SERVICE BUREAU,
Petitioner.

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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KLAMATH MEDICAL SERVICE BUREAU,
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COMMISSIONER OF INTERNAL REVENUE,
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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit, entered in the above entitled case on December 15, 1958, with the denial of petition for rehearing on January 26, 1959.

CITATIONS TO OPINIONS BELOW

The opinion of the Tax Court of the United States is printed (R. 23-44), and is reported in 29 T.C. 339. The opinion of the Court of Appeals, printed in Appendix B hereto, infra, page 16, is reported in F.2d

JURISDICTION

The judgment of the Court of Appeals was entered December 15, 1958 (R. 200). Rehearing was denied on January 26, 1959 (R. 201). The jurisdiction of this court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

1. A corporation makes payments based upon net profits pursuant to corporate resolutions characterizing the payments as fees for services rendered by physicians who are both employees and stockholders of the corporation.

2. The payments are in direct proportion to the services actually rendered by each physician, the sums paid are reasonable for the services rendered, and the payments bear absolutely no relationship to the stock held by each physician in the corporation.

Are the payments "COMPENSATION," and if so are they "NECESSARY" so as to constitute a deduction within the meaning of Section 23(a) of the Internal Revenue Code of 1939 (Section 162 of the 1954 Code)?

The United States Court of Appeals for the Ninth Circuit says: No, a portion of such payments is a distribution of profits or if compensation, is not a "necessary" business expense because there was no contract obligation requiring payment.

STATUTES AND REGULATIONS INVOLVED

The Federal Statute and Treasury Regulations involved are:

Internal Revenue Code of 1939, Section 23(a)(1), 26 U.S.C., Section 23.
Treasury Regulations 118, Section 39.23(a)-6 and 39.23(a)-8.

They are printed in Appendix A, infra, page 13.

STATEMENT

This action involves the Federal Income Tax liability of petitioner for the fiscal years ending June 30, 1951, 1952 and 1953. In September of 1955, the respondent assessed a deficiency against petitioner. The deficiency was based upon the respondent disallowing as a business expense payments of $211,852.09 paid by the petitioner in the three years to physicians for professional medical services. Respondent contended that the payments were in fact distributions of earnings and were unreasonable in amount (R. 13). The petitioner timely filed its petition with the Tax Court of the United States protesting the deficiency and asserting that the payments were deductions under Section 23(a) of the Internal Revenue Code of 1939. Following a trial upon the issues before the Tax Court of the United States, the Tax Court found that the total payments deducted by petitioner were reasonable, but that a portion of the amount which had been disallowed by respondent was a distribution of profits. The decision of the Tax Court (R. 44) assessed a total deficiency against petitioner of $85,825.50.

Petitioner filed a petition for review of the decision of the Tax Court before the United States Court of Appeals for the Ninth Circuit which affirmed on the ground that the decision of the Tax Court was not clearly erroneous, and held in addition that even if the payments in question were compensation, they were not "necessary" since they were not paid pursuant to a binding contract obligation (Appendix B 26). The judgment of the Court of Appeals was entered on December 15, 1958, and thereafter on January 26, 1959, petitioner's timely petition for rehearing was denied without opinion (R. 201).

Petitioner is a hospital association organized under the laws of the State of Oregon in 1939, primarily engaged in the business of selling prepaid medical, surgical and hospital plans or contracts in Klamath County, Oregon, and providing the medical and surgical services and the hospitalization required under such plans or contracts (R. 50-53). Petitioner, since its inception, has entered into employment agreements with all of the physicians and surgeons of the Klamath County Medical Society to render medical services to petitioner's subscribers. Each of these physicians and surgeons own one share of stock of petitioner (R. 59, 107). The physicians and surgeons bill the petitioner for services rendered to the subscribers of petitioner. Such billing is based upon a fee schedule maintained by the petitioner (R. 53). The employment agreement between the physicians and the petitioner provided for payment of such percentage of the doctors' billings based on the fee schedule, as the total income of the petitioner would

permit after deducting all other business expenses and such amounts as the Board of Directors of the corporation should desire to retain for corporate purposes (R. 53). The purpose of the fee schedule was to differentiate between particular medical and surgical procedures and to insure that the payment to the physicians would be in proportion to the services that each rendered (R. 28). In some of the years ending prior to June 30, 1951, the physicians received less than the amount of their billings (R. 29). In the years in question the physicians received an amount greater than their billings. There has never been any question that the services billed were rendered and paid for in the years in question (R. 43). The total amounts paid to the physicians in the years in question were authorized by appropriate corporate resolutions characterizing the payments as fees for professional services (R. 54, 103). The total payments to the physicians were unreasonably low for the services rendered, even when the advantages of petitioner's bearing a portion of the cost which private practitioners would otherwise be forced to defray, was taken into consideration (R. 43).

The Tax Court concluded that the Agreement of Employment between the doctors and the petitioner was ambiguous and did not authorize compensation payments greater than the amounts provided in the fee schedule (R. 38). The Tax Court further concluded that since the amounts in excess of those listed in the fee schedule were paid from earnings and based upon earnings in excess of amounts necessary for the operation, planned expansion and reserves of petitioner, such

amounts were distributions of profits to its stockholders (R. 41).

The Court of Appeals did not reexamine the question of law involved concerning the ambiguity of the contract, but held only that the ultimate finding of the Tax Court was not clearly erroneous (Appendix B 25). The Court of Appeals did, however, accept the conclusion of ambiguity and ruled that even if the portion of the payments disallowed was compensation it was not "necessary" since there was no binding contract obligation which required petitioner to pay compensation in excess of the amounts billed by the physicians (Appendix B 26).

The only statute involved is Section 23(a) of the Internal Revenue Code of 1939. The Code itself defines neither "necessary" nor "compensation." The only definitive statement concerning compensation is contained in the Treasury Regulations promulgated under the statute. Treasury Regulation 118, Sec. 39.23 (a)-6 provides what is termed a "practical application" of the test of whether purported compensation is in fact a distribution of a dividend on stock. Both the statute and regulations are set forth in Appendix A, *infra*.

REASONS FOR GRANTING THE WRIT

Perhaps no provision of the tax law has engendered more litigation and affected more taxpayers than the provision allowing a deduction for ordinary and necessary business expenses. The numerous decisions have evidently not served to settle matters. One reason for

the continued litigation in this field is that judicial construction of the statute and regulations has been necessarily uncoordinated and has "operated to put * * * unintended power in the hands of that congeries of subordinates known as 'the Commissioner'." Erwin E. Griswold, The Deduction of "A Reasonable Allowance for Salaries"—The Undefined Power of the Commissioner, 56 Harvard Law Review 997. It is understandable that such additional power should be utilized.

The decision of the Court of Appeals has greatly extended the power of the respondent in two respects. First, any business expense claimed by a taxpayer—no matter how "ordinary"—may be disallowed as unnecessary if there exists no legal obligation to pay it. In addition, an unnecessarily narrowed definition of "compensation" enables respondent to determine that purported compensation is in reality dividends whenever payments to employee-stockholders are based on profits. The statutory provision which began as a limitation upon the power of the respondent, Erwin N. Griswold, New Light on "A Reasonable Allowance for Salaries," 59 Harvard Law Review 286, and even recently was described as a "negative power" which is not to be used to determine what salaries should be, *Yuenger Mfg. Co. v. U. S.*, 57-1 USTC ¶ 9417 (D.C. Ill., 1957), has become a formidable weapon which may be successfully wielded against every business which attempts to tie the success of its employees to the success of the business or fails to insist on a binding contract before disbursing expenses of any nature. Such a weapon will be used, and its use will allow this section of the Internal Reve-

nue Code to continue to spawn enormous amounts of litigation.

One result of this extension of power is to make the so-called burden of proof of the taxpayer insurmountable where the taxpayer uses a compensation plan based on profits. Such an extension abrogates the holdings which have stated that "the policy of agreeing to pay a percentage of earnings before they are earned, or even a sum in the nature of a bonus after they are earned, is based primarily upon sound business principles." *Mayson Mfg. Co. v. CIR*, 178 F.2d 115 (C.A. 6th, 1949) and *William S. Gray v. U. S.*, 35 F.2d 963 (1925).

Under the holding of the lower court it avails the taxpayer nothing to affirmatively establish those criteria which are set forth in existing authorities as determining whether payments to stockholder-employees are compensation. An employer may show that the employees rendered substantial services, were paid in direct proportion to those services and were paid amounts reasonable for the services performed. The employer may further show that the payments were authorized by corporate resolutions as compensation and bore no relation to the stockholdings of the employees. These are the criteria which are stressed in existing case law. *Ox Fiber Brush Co. v. Blair*, 32 F.2d 42 (CCA 4th, 1929); *Am-Plus Storage Battery Co. v. CIR*, 35 F.2d 167 (CCA 7th, 1929); *Heil Beauty Supplies v. CIR*, 199 F.2d 193 (CA 8th, 1952); *Long Island Drug Co., Inc.*, 35 BTA 328, Aff'd. 111 F.2d 593 (CCA 2d, 1940), certiorari denied 311 U.S. 680 and *Botany Worsted Mills v. U. S.*, 278 U.S. 282, 49 S. Ct. 149 (1928).

However, such a showing will not deter the respondent from assessing deficiencies in the future if the decision of the lower court is allowed to stand. It is not difficult to imagine the increased number of administrative proceedings and court cases which will arise because of this new grant of power to the respondent. No true solution to the problem is found in advising an employer not to tie compensation to profits. A hospital association such as petitioner, must adopt a plan which makes costs dependent upon income if it is to assure performance of its duty to provide an unknown amount of medical service to its subscribers on a fixed amount of income. Commercial businesses have found bonuses and commissions based upon profits a most effective way to reward the industry of their employees. It is certainly not desirable to force employers, through sanctions imposed by the tax laws, to discard compensation arrangements which have proved a stimulant to business growth and are in some cases necessary to the continuation of business.

Unfortunately, in the mass of cases which have been concerned with distinguishing compensation from dividends, no single case has purported to set forth all the criteria to be employed in deciding the question in issue. It is respectfully submitted that this Court should exercise its supervisory powers to guide not only the lower courts, but also employers and personnel of the Internal Revenue Service. In this regard, an amplification of the opinion of this Court in *Botany Worsted Mills v. U. S.*, *supra*, relating to distributions of profits in the guise of compensation is necessary. The question presented re-

lates primarily to the criteria to be employed in determining the factual issue. This is a question of law which the Court has seen fit to answer in other tax cases. *Guggenheim v. Rasquin*, 312 U.S. 254, 61 S. Ct. 507 1940); *CIR v. Flowers*, 326 U.S. 465, 66 S. Ct. 250, and see *Peurifoy v. CIR*, ... U.S. ..., 79 S. Ct. 104 (Nov. 10, 1958).

The Court of Appeals in volunteering the conclusion (without the urging of either petitioner or respondent and without citation of authority) that the payments to the employees of petitioner were not "necessary" because there was no contractual obligation to pay them, acted contrary to the pronouncements of this Court in *CIR v. Ox Fiber Brush Co.*, 281 U.S. 115, 50 S. Ct. 273 (1930) and *Welsh v. Helvering*, 290 U.S. 111, 54 S. Ct. 8 (1933). The language of the Court of Appeals in this regard leaves no bonus, pension or other payment of a voluntary nature free from attack by the respondent as an unnecessary disbursement. Such a rule is contrary to the regulations enacted by the Treasury Department, Treasury Regulation 118, Sec. 39.23(a)-8, and the established cases. Such a holding will similarly effect those thousands of employers and employees who have desired to reward or have been rewarded by voluntary payments which stimulate business and reward industry.

CONCLUSION

For the foregoing reasons this petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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APPENDIX A

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

Sec. 39.23(a)-6 *Compensation for personal services.* (a) There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actual rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to

occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is

in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

Sec. 39.23(a)-8 Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are not deductible from gross income.

APPENDIX B

Opinion of United States Court of Appeals for the Ninth Circuit, BARNES, Circuit Judge:

This is a petition for review of federal income taxes for the years 1951, 1952 and 1953. Timely petition to this Court was made after decision in the Tax Court. This Court has jurisdiction under Int. Rev. Code of 1954 § 7482, 26 U.S.C. § 7482.

The question presented is whether the Tax Court's determination that those amounts distributed by taxpayer to its stockholder physicians in excess of their billings for services rendered were nondeductible distributions of corporate income, rather than compensation for personal services within the meaning of § 23(a) of the Int. Rev. Code of 1939.[1] The corporation took the latter position and accordingly filed returns on this basis during the years in question. The Commissioner rejected this and determined deficiencies.

I - Facts

The case was submitted on a stipulation of facts supported by exhibits and some oral testimony. The

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[1] Int. Rev. Code of 1939, as amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798:

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) EXPENSES.—

(1) TRADE OR BUSINESS EXPENSES.—

(A) IN GENERAL.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. . . ."

facts must be understood. As found by the Tax Court, they may be summarized briefly as follows:

Petitioner is an Oregon corporation, organized in 1939, largely engaged in the business of selling prepaid medical, surgical and hospital plans or contracts in Klamath County, Oregon, and providing the medical and surgical services and hospitalization required under the plans and contracts. A primary source of petitioner's income is the premiums paid on the plans and contracts sold. Some other income is also received by petitioner from non-contract patients using the hospital facilities owned by petitioner. Stock ownership is limited to members of the Klamath County Medical Association. To provide this service which it contracts to supply, petitioner entered into contracts with all members of the County Medical Association, whereby they agreed to perform the services necessary. Under these contracts the doctors agreed to a schedule of base fees for each service which they performed and were to be paid according to a complex formula. The formula provides that when a doctor bills the Medical Service Bureau for a service he has rendered a patient, within thirty days the Bureau is to pay him fifty per cent of the base fee. Then every six months the petitioner is to pay him (less the fifty per cent already paid) *a percentage of the base fees* billed by the doctor, determined by the ratio which the total net income of petitioner (less certain amounts determined by the board to be necessary for corporate purposes) bears to the total fees billed by all the physicians during that six month period. In short, the petitioner determines what its net profit will

be, deducts amounts necessary for retiring bonds, etc., and then pays out a percentage of its profits to the doctors, regardless of what the fee schedule amount would be, since the latter is only a *base* fee. During the years in question these payments amounted to 116.9, 115.7, and 134.3 per cent of each physicians' billings for the three years, so that in each year the excess over 100 per cent represented payments in excess of the fee schedule.

The Tax Court specifically found that while the fee schedule was unreasonably low when compared to like services and procedures and compensation charged therefor by physicians in private practice, it was equitable and fair when the lessened costs to doctors rendering services under the plan (which lessened costs are attributable to taxpayer's operation) were considered. None of the fees set were unreasonable in amount, and it was held that 100 per cent of the billings of physicians constituted reasonable compensation for the services for which taxpayer was billed.

From 1940 to 1943 petitioner operated solely as a service bureau and its income was solely from premiums on the contracts for medical care. However, in 1943 taxpayer bought the Hillside Hospital and in 1946 bought the Klamath Valley Hospital, and the Valley Hotel. Since that time, part of its income has come from the operation of these facilities.

Under its subscriber contracts services are furnished, except in emergency situations, by taxpayer's physician-stockholder-members and hospital services by the petitioner's hospitals. Subscribers away from Klamath in

emergency cases may seek local care and petitioner will bear the cost of the services up to the limit of the fee schedule. Two individual contracts with subscribers exist under which the physician members agree "to accept K.M.S.B. Fees *as full payment* for Services for all eligible persons" whose family net income is less than $5,000 per year, and when the income exceeds this amount, then as to the amount charged by a physician, "Benefit payments made to the member by K.M.S.B. will act as a credit to total charges. Benefits Are the Same for All Persons Regardless of Income." There was testimony to the effect that use was not made of the clause pertaining to those earning over $5,000.

Finally, all members of the petitioner obligated themselves to resell their stock in petitioner if they left the area or retired. They agreed that no member could sell his share without the written consent of taxpayer's board of directors, and within thirty days after notice to taxpayer of intention to sell, the taxpayer agreed to purchase all such stock at book value. In determining book value, the unpaid medical service charges on the part of taxpayer's member-physicians were to be valued at 100 per cent of the billings of such physicians.

The taxpayer's fee schedule was altered and amended, generally upward, from time to time to bring it more nearly level with charges by physicians in private practice. The schedule was used for the purpose of differentiating between medical and surgical procedures and to ensure that member physicians would receive like compensation for like services.

The Commissioner and the Tax Court disallowed as deductions by petitioner, for compensation to member doctors, all sums paid in excess of 100 per cent of the base fee schedule fees billed and approved for each doctor.

II - The Law

The sole issue is: May petitioner deduct as "compensation," payments to its stockholder-member-physicians in excess of 100 per cent of base fee billings by its members?

Petitioner specifies as the primary error the finding and conclusion of the Tax Court that the excess over the 100 per cent of base fee billings was distribution of profits rather than compensation for services. Further error is urged in the subsidiary findings and conclusions that underlie the alleged primary error, to wit: that the contracts with the doctors were ambiguous when interpreted as obligating the doctors to perform their services for no more than the base fee schedule amounts; that this was part of a method of paying out earnings rather than compensating the doctors for their services; and that the fact that in some earlier years the doctors may have received *less* than 100 per cent of the base fees may not be taken into consideration here.

Petitioner's argument is based on three factors drawn from reading and interpreting Reg. 118, § 39.23(a)-6, promulgated under the Int. Rev. Code of 1939.[2] Peti-

[2] "Sec. 39.23(a)-6 COMPENSATION FOR PERSONAL SERVICES. (a) There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a rea-

tioner claims that in this area all cases based on the said regulation have established three tests: (1) Do the

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sonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly from services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual; it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned."

payments made bear any relation to the stockholdings? (Here, the answer is no, since all doctors have one share each, but are paid amounts differing by reason of the services performed); (2) Are the payments made in proportion to services rendered? (Here, that fact is undenied.); and (3) Are the payments reasonable in amount? (The Court held that they were reasonable up to 100 per cent, and indicated that it felt they would also be reasonable up to the amounts actually paid.) Thus, says petitioner, since there is no case to be found where all of these things were answered properly and the amounts denied as deductions for compensation, the Tax Court must be wrong. Furthermore, the amounts were always intended and characterized as compensation for services. Petitioner cites many cases to the effect that if one element or another be missing, the courts will disallow the deduction; and many cases showing that where the compensation was reasonable it is allowable as such, even though this may mean that the corporation has no profits. Compare, however, *e.g.*, *Am-Plus Storage Battery Co. v. Comm'r*, 7 Cir., 1929, 35 F.2d 167, 168-69. Furthermore, petitioner argues that the findings and conclusions of the Tax Court on the subsidiary holdings are not justified by the evidence, primarily because petitioner seems to think the court places too much emphasis on the fact that the compensation of the doctors was based on a percentage of the net profits and that the doctors had agreed to the base fee schedule. As petitioner points out, in a proper case, there is nothing wrong with a corporation paying compensation on a percentage of profits if it is reasonable and paid in accordance with

services rendered. See *William S. Gray & Co. v. United States*, 35 F.2d 968 (Ct. Cl., 1929) where such an arrangement was allowed, citing other cases to the same effect.

The government admits much of what petitioner claims is the law, but points out that its (petitioner's) brief overlooks a basic point of the Tax Court decision—that the Tax Court found initially that payment of the amounts over 100 per cent were not compensation, but rather a guise for distributing corporate profits.[3]

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[3] "We think it must be concluded from this record that, with respect to that portion of the payments here involved which exceed 100 per cent of the billings of petitioner's staff doctors, such payments were distributions of petitioner's profits and earnings. We are led to this conclusion because of the contract under which petitioner was bound to pay its member doctors for their services rendered. That instrument is ambiguous with respect to the compensation for such services. It does not specifically provide for the payment of over 100 per cent of the billings for such services but does provide specifically that the billings be in accordance with its fee schedule. It also provides specifically that staff physicians will furnish professional service to petitioner's subscribers in accordance with the terms and limitations of the contract between petitioner and such subscribers. It is also noted therein that the individual member physician has read such contracts. We assume therefrom he was fully aware of the terms thereof when executing his employment contract with petitioner. Two of the contracts by which petitioner sells its services to subscribers provide on their faces that petitioner's member physicians accept petitioner's fees as payment in full for services to persons or employees or their families whose net income is less than $5,000 per year. It is provided further that, when the family income is in excess of $5,000 per year, the subscriber must make his own arrangements with the physician regarding fees in which event 'Benefit payments made to the member by K.M.S.B. (petitioner) will act as a credit to total charges.' It seems clear from this that petitioner has contracted with its member physicians that they will render their services to petitioner for fees equal to its fee schedule, regardless of the fact that such fees may be in some instances below reasonable compensation therefor. This is not unrealistic when it is considered that staff doctors do not bear certain office administrative expense in their rendition of services to

The government would have us note these other factors: (1) If this arrangement is condoned, the taxpayer may well be able to pay out year after year all its profits in the form of compensation, and never pay taxes; (2) the petitioner's argument conveniently overlooks the fact that some of the income of the corporation passed along to the doctors as compensation for their services comes from the operation of the hospitals, and not from their services; (3) that the rate schedule was raised several times in several years, indicating an intention of the doctors to have this varying schedule of fees represent the amount of compensation they were to get; (4) the amount received by the doctors, if limited to the base fee schedule amount, still constitutes a reasonable compensation, since there are certain savings to the doctors under this arrangement, not to mention the convenience of owning their own hospitals; and finally, (5) the petitioner conveniently overlooks the fact that the burden of proving that this amount over 100 per cent is *in fact* compensation and not a distribution of profits, is on the

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petitioner's subscribers which would be borne by them with respect to private patients. One hundred per cent of the billings of staff doctors for services rendered constitute the total expense for such services for which petitioner is liable under its employment contract. There is no express contract requirement that they be paid in excess of 100 per cent of billings for their service.

That petitioner intended to distribute earnings under the guise of payment for services rendered seems clear to us in the light of the testimony of the president of petitioner's board of directors during the years at issue. . . .

* * *

It seems clear from this testimony that under its contract with member physicians petitioner intended that all of its earnings in excess of amounts necessary for its operation, planned expansion and reserves were to be distributed to its member-stockholder physicians. Viewed in that light the contract provides not only a method of computation for services rendered but also a method of distribution of its profits to its stockholders."

petitioner; and the trier of fact simply did not think this burden was satisfied. The government argues that since the Tax Court found initially that this payment over 100 per cent was not compensation, the element of reasonableness never enters into the picture after that point. *Twin City Tile & M. Co. v. Comm'r,* 8 Cir., 1929, 32 F.2d 229. The question of the character of the sums paid is basically a question of fact, which the Tax Court found against the petitioner.

The Commissioner was the prevailing party below, and hence we must take that view of the evidence most favorable to him. He is entitled to the benefit of all favorable inferences from the facts proved. If, when so viewed, there was substantial evidence to sustain the findings of the Tax Court, then the judgment may not be reversed by this Court unless the clear weight of the evidence is against it, or the trial court was influenced by an erroneous view of the law. *Stacher v. United States,* 9 Cir., 1958, 258 F.2d 112, 116; *John Hancock Life Ins. Co. v. Cohen,* 9 Cir., 1958, 254 F.2d 417; *Vidales v. Brownell,* 9 Cir., 1954, 217 F.2d 136.

There is another reason why we believe the judgment of the Tax Court was correct. As the Tax Court interpreted a contract it found to be ambiguous, the petitioner's members had signed contracts with it whereby the petitioner was obligated to pay them 100 per cent of the base fee (however and at whatever figure it was set), *but no more!* Any amount over and beyond the 100 per cent base fee could, or could not, be paid to the doctor-members, as the management saw fit. The petitioner could use it for the buying of office equip-

ment or equipment for the hospital, or new hospitals, or even a hotel. This voluntary payment to the doctors of more than the 100 per cent of base pay the doctors had agreed to accept as compensation in full for their services, might be an ordinary, but could not be a necessary, expense and hence, not an *ordinary* and *neces*- in § 23(a) of the Int. Rev. Code of 1939; and the only deduction allowable thereunder.

We cannot conclude the Tax Court was clearly erroneous in its decision, and its decision is therefore *affirmed*.

(Endorsed:) Opinion. Filed Dec. 15, 1958.

Paul P. O'Brien, Clerk.

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No. 705

In the Supreme Court of the United States

October Term, 1959

KLAMATH [illegible], PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

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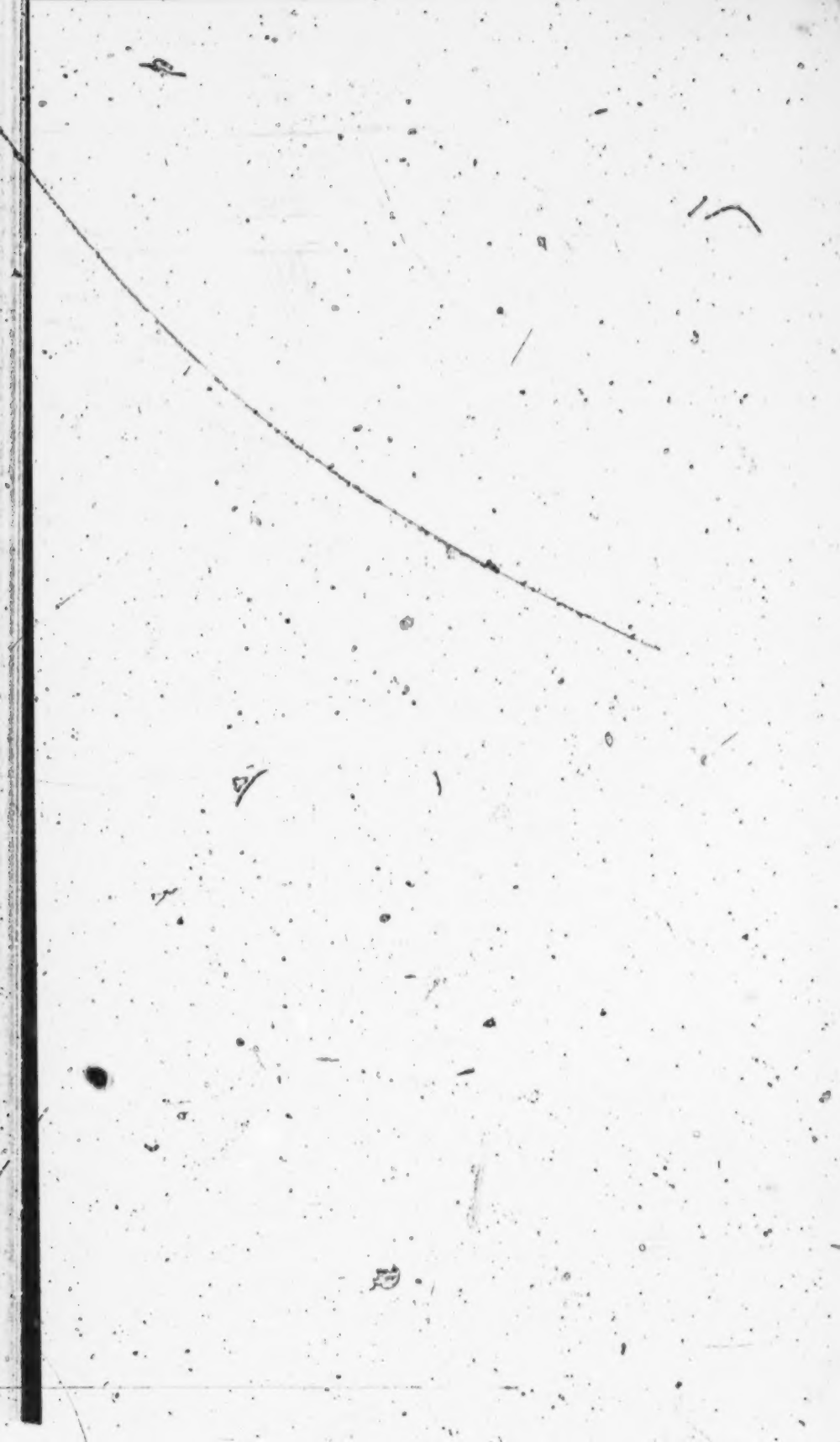

In the Supreme Court of the United States

OCTOBER TERM, 1958

No. 731

KLAMATH MEDICAL SERVICE BUREAU, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 23-44) are reported at 29 T.C. 339. The opinion of the Court of Appeals (Pet. 16-26) is reported at 261 F. 2d 842.

JURISDICTION

The judgment of the Court of Appeals was entered on December 15, 1958. (R. 200.) A timely petition for rehearing was denied on January 26, 1959. (R. 201.) The petition for a writ of certiorari was filed on February 27, 1959. The juris-

diction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Whether amounts distributed by taxpayer to its stockholder-physicians in excess of their billings for services rendered were nondeductible distributions of corporate income, rather than compensation for personal services within the meaning of Section 23(a) of the Internal Revenue Code of 1939.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) [amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—
>
> (1) *Trade or business expenses.*—
>
> (A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; • • •.
>
> • • • • •
>
> (26 U.S.C. 1952 ed., Sec. 23.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

> SEC. 39.23(a)-6 *Compensation for personal services.* (a) There may be included among the

ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonsonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939, Section 29.23(a)-6, applicable for the fiscal years ending June 30, 1951 and 1952, contains substantially the same provisions as Treasury Regulations 118, Section 39.23(a)-6.

STATEMENT

The facts, as found by the Tax Court, may be summarized as follows:

Taxpayer is an Oregon corporation, organized in 1939, largely engaged in the business of selling prepaid medical, surgical, and hospital plans or contracts in Klamath County, Oregon, and providing the medical and surgical services and hospitalization required under the plans and contracts. A primary source of taxpayer's income is the premiums paid on the plans and contracts sold. Some other income is also received by taxpayer from non-contract patients using the hospital facilities owned by taxpayer. Stock ownership is limited to members of the Klamath County Medical Association. To provide the service which it contracts to supply, taxpayer entered into contracts with all members of the County Medical Association, whereby they agreed to perform the services necessary. Under these contracts, the doctors agreed to a schedule of base fees for each service which they performed and were to be paid according to a complex formula. The formula provides that when a doctor bills the Medical Service Bureau for a service he has rendered a patient, within thirty days the Bureau is to pay him fifty per cent of the base fee. Then every six months the taxpayer is to pay him (less the fifty per cent already paid) *a percentage of the base fees* billed by the doctor, determined by the ratio which the total net income of taxpayer (less certain amounts determined by the board to be necessary for corporate purposes) bears to the total fees billed by all the physicians during that six month period. During the

years in question, these payments amounted to 116.9, 115.7, and 134.3 per cent of each physician's billings for the three years, so that in each year the excess over 100 per cent represented payments in excess of the fee schedule. (Pet. 17-18.)

From 1940 to 1943, taxpayer operated solely as a service bureau and its income was solely from premiums on the contracts for medical care. However, in 1943 taxpayer bought the Hillside Hospital, and in 1946 bought the Klamath Valley Hospital and the Valley Hotel. Since that time, part of its income has come from the operation of these facilities. (Pet. 18.)

Under its subscriber contracts, services are furnished, except in emergency situations, by taxpayer's physician-stockholder-members, and hospital services by the taxpayer's hospitals. Subscribers away from Klamath in emergency cases may seek local care and taxpayer will bear the cost of the services up to the limit of the fee schedule.

There are two individual contracts with subscribers. Where family net income is less than $5,000 per year, the physician members agree "to accept K.M.S.B. Fees as full payment for Services for all eligible persons". Where family income exceeds this amount, then as to the amount charged by a physician, "Benefit payments made to the member by K.M.S.B. will act as a credit to total charges. Benefits Are the Same for All Persons Regardless of Income." There was testimony to the effect that use was not made of the clause pertaining to those earning over $5,000. (Pet. 18-19.)

Finally, all members of the taxpayer obligated themselves to resell their stock if they left the area or retired. They agreed that no member could sell his share without the written consent of taxpayer's board of directors, and within thirty days after notice to taxpayer of intention to sell, the taxpayer agreed to purchase all such stock at book value. In determining book value, the unpaid medical service charges on the part of taxpayer's member-physicians were to be valued at 100 per cent of the billings of such physicians. (Pet. 19.)

The taxpayer's fee schedule was altered and amended, generally upward, from time to time to bring it more nearly level with charges by physicians in private practice. The schedule was used for the purpose of differentiating between medical and surgical procedures, and to ensure that member physicians would receive like compensation for like services. (Pet. 19.)

The Tax Court specifically found that while the fee schedule was unreasonably low when compared to like services, procedures, and compensation charged therefor by physicians in private practice, it was equitable and fair when the lessened costs to doctors rendering services under the plan (which lessened costs are attributable to taxpayer's operation) were considered. None of the fees set were unreasonable in amount, and it was held that 100 per cent of the billings of physicians constituted reasonable compensation for the services for which taxpayer was billed. (Pet. 18.)

The Commissioner and the Tax Court disallowed the deduction of all payments made by the taxpayer to the stockholder-physicians in excess of 100 per cent of the base fees for services rendered, billed by, and approved for each of them on the ground that such excess represented distributions of the earnings of the taxpayer and not compensation to the physicians. (R. 24, Pet. 20.)

The Court of Appeals accepted the findings of fact of the Tax Court (Pet. 17-19, 25), held that it had not erroneously applied the law (Pet. 25), and accordingly affirmed its decision (Pet. 26).

ARGUMENT

The question presented here is a factual one on which the courts below agreed and there is no conflict with the decisions of this Court or other Courts of Appeals.

Whether payments by a corporation to its stockholder-employees are compensation or dividends, and whether compensation, claimed as a deduction, is reasonable in amount, are questions of fact. It has long been established that in determining these questions all circumstances must be taken into consideration, no one factor being decisive. See, for example, *Jacobs & Davies* v. *Anderson*, 228 Fed. 505 (C. A. 2d); *Becker Bros.* v. *United States*, 7 F. 2d 3, 7 (C. A. 2d); *Twin City Tile & M. Co.* v. *Commissioner*, 82 F. 2d 229, 231 (C. A. 8th); *William S. Gray & Co.* v. *United States*, 35 F. 2d 968 (C. Cls.); *Am-Plus Storage B. Co.* v. *Commissioner*, 35 F. 2d 167 (C. A. 7th); *E. Wagner & Son* v. *Commissioner*, 93 F. 2d

816 (C. A. 9th); *Doernbecher Mfg. Co.* v. *Commissioner*, 95 F. 2d 296 (C. A. 9th); *Marble & Shattuck Chair Co.* v. *Commissioner*, 39 F. 2d 393 (C. A. 6th); *Long Island Drug Co.* v. *Commissioner*, 111 F. 2d 593, 594 (C. A. 2d); *Mayson Mfg. Co.* v. *Commissioner*, 178 F. 2d 115, 119 (C. A. 6th); 4 Mertens, *Law of Federal Income Taxation* (Rev.), Sections 25.64, 25.68. The courts below followed this accepted rule in resolving the issue here.

In the present case there are circumstances, recited in the opinion of the Court of Appeals (Pet. 21-23), which, arguably, could lead to the finding that the amounts paid above 100 per cent of billings were compensation, and were reasonable. On the other hand, there are important circumstances to the contrary, also recited in the opinion. (Pet. 24.) Taking all the circumstances into consideration, and finding no one factor decisive, the courts below found that the payments above 100 per cent of billings were not deductible compensation but were distributions of earnings. By its petition, the taxpayer is here seeking a second appellate review of this factual determination.

The opinion below did not set out any new principle of law, nor is there any conflict with principles of law laid down by this Court or by other Courts of Appeals. In *Commissioner* v. *Flowers*, 326 U. S. 465, 470, this Court pointed out that the question of deductibility of expenses is usually a question of fact for the Tax Court. In *Peurifoy* v. *Commissioner*, 358 U. S. 59, it refused to intervene in the determination of a fact question. In *Lucas* v. *Ox Fibre*

Brush Co., 281 U. S. 115, the question of the reasonableness of the payments was not in issue before this Court nor is the instant decision contrary, as taxpayer asserts (Pet. 10), to the pronouncements made therein. The courts below, in line with *Botany Mills* v. *United States*, 278 U. S. 282, 288-290, and *Welch* v. *Helvering*, 290 U. S. 111, correctly held that the burden was on the taxpayer to establish its right to the deduction.

Taxpayer (Pet. 7) objects to the additional reason given by the Court of Appeals for affirming the decision of the Tax Court, namely that the payments above 100 per cent of billings were not necessary expenses (Pet. 25-26). This comment, unnecessary for the decision of the case, did not purport to set out as a general principle, divorced from the particular situation of this taxpayer, a rule that voluntary payments of additional compensation can never be an ordinary and necessary expense. Here again, the court was dealing with the facts of a single case. In the light of the history of taxpayer's activities, a conclusion that voluntary payments to the doctors above 100 per cent of their agreed-upon fee schedule were not a necessary expense was, we submit, a permissible one.

Finally, the taxpayer requests this Court to intervene in order to set forth "all the criteria to be employed in deciding the question in issue." (Pet. 9.) This request, however, merely reflects the dissatisfaction of taxpayer with the weight given by the courts below to the different factors here present, or, perhaps, a desire to have this Court say that some one

criterion is decisive. In either event, we submit that there is no showing of a conflict of principle among the Courts of Appeals, nor of difficulty in determining the appropriate criteria, such as to call for further review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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MARCH, 1959.

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